Compliance and Supervision of Complex Products

James Fago
Metlife Premier Client Group

Ben Indek (Moderator)
Morgan, Lewis & Bockius LLP

Darrell Jackson
Wells Fargo Advisors

Brad Nassau
Gatland & Mellina Group

Erik Paulsen
U.S. Bancorp

Karleen Perry
D.A. Davidson & Co.

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I. INTRODUCTION[1]

Over the last several years, regulators have exhibited significant concerns regarding the so-called "retailization" of complex products to individual investors. These concerns have been set out in various regulatory notices, examination priorities, and enforcement efforts. This outline highlights these issues.

II. REGULATORY NOTICES

A. New Products – NASD Recommends Best Practices for Reviewing New Products.

In Notice to Members 05-26 (September 2005), NASD stated that it was concerned about the rising number of ever increasingly complex products being offered by member firms.

(i) Some products have features that may not be fully understood by investors or registered representatives; and

(ii) Some products raised suitability and conflict of interest concerns.

The NASD urged firms to be proactive in reviewing and improving their procedures for creating and vetting new products. The NASD stated that all firms offering new products should have formal written procedures to confirm that no new product is introduced before it has been fully vetted. At a minimum, such procedures should identify what constitutes a new product and confirm that the right questions are asked and answered before a product is offered to clients.

After surveying firms, the NASD noted the following best practices:

(i) "A mandatory, standardized process that requires a written "new product" proposal and thorough accompanying documentation;

(ii) A preliminary assessment of a proposed product or concept by compliance and/or legal personnel to determine, among other things, whether it is a new product or a material modification of an existing product, and the appropriate level of internal review;

(iii) For new products or material modifications to existing products, detailed review by a committee or working group made up of representatives from all relevant sectors of the firm, including compliance, legal, finance, marketing, sales and operations;

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[1] This outline was drafted by Ben A. Indek and Vivian E. Kim, a partner and associate, respectively of Morgan, Lewis & Bockius LLP. The outline represents the views of Mr. Indek and not those of the other panelists and their organizations or the Firm's clients. Portions of this outline were developed by Mr. Indek for use at various SIFMA Compliance & Legal Division Seminars. Mr. Indek is indebted to the panelists at those seminars for their input on those outlines.

(iv) A formal decision to approve, disapprove, or table the proposal by a new product committee or other decision-making group that includes members of the firm's senior management; and

(v) If the product is approved, some level of post-approval follow-up and review, particularly for products that are complex or are approved only for limited distribution."

B. Structured Products – NASD Provides Guidance Concerning the Sale of Structured Products

Definition: according to the NASD, structured products are "securities derived from, or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or a foreign currency." Their characteristics include:

(i) Principal protection varies – may offer full or limited protection of the principal invested, or none at all.

(ii) Most pay an interest rate substantially above prevailing market.

(iii) Are typically issued by investment banks or their affiliates.

(iv) Have a fixed maturity.

(v) Are sometimes listed on an exchange, but in such cases, generally are very thinly traded.

Structured as two components – a note and a derivative (often an option):

(i) Note pays interest to the investor at specified rate and interval.

(ii) Derivative component establishes payment at maturity (effectively acting like a put or call option).

NASD's 2005 guidance (Notice to Members 05-59) on structured products states firms should:

(i) provide balanced disclosure in promotional efforts;

(ii) ascertain accounts eligible to purchase structured products;

(iii) deal fairly with customers with regard to derivative products;

(iv) perform a reasonable-basis suitability determination;

(v) perform a customer-specific suitability determination;

(vi) supervise and maintain a supervisory control system; and

(vii) train associated persons.

Balanced disclosure should not portray a product as "conservative" or a source of "predictable current income" unless such statements are accurate, fair, and balanced. In promoting advantages such as interest rate offered and creditworthiness of the company, a firm must balance its presentation with disclosures concerning risks, e.g., loss of principal and the possibility that at expiration the investor will own the reference asset at a lower price. Sales materials and oral presentations that omit description of the derivative component and instead present such products as ordinary debt securities would violate Rule 2210. Firms should also balance any statements that a structured product has a ticker symbol or has been approved for listing on an exchange with the risks that an active and liquid trading market may not develop in the future.

The NASD cautioned that presentation of a credit rating for a structured product suggesting that the rating relates to the safety of the money invested or the likely investment returns will be seen as misleading by the staff. The Notice further states "creditworthiness of the issuer does not affect or enhance the likely performance of the investment, other than the ability of the issuer to meet its obligations."

Eligible Accounts:

(i) Firms should consider whether structured products should be limited to clients approved for options accounts.

(ii) Otherwise, the member must develop (and be prepared to defend) comparable procedures designed to confirm that structured products are only sold to persons for whom risk is appropriate.

(iii) Due to potential conflicts of interest, sale of a firm's or affiliate's structured product to a discretionary account requires the client's prior specific written approval of the trade.

Fair Dealing:

(i) "Member must be familiar with each customer's financial situation, trading experience, and ability to meet the risks involved with such products and make every effort to make customers aware of the pertinent information regarding the products."

Reasonable Basis Suitability:

(i) This aspect of suitability includes due diligence.

(ii) NASD expects members to exercise market expertise to identify where a lower yielding instrument does not represent a reasonable rate of return, given the attendant risks, as compared to other

similar products or direct investments in the underlying securities with similar risk/reward attributes.

Customer-Specific Suitability:

(i) Derivative component and potential loss of principal may be unsuitable for investors seeking alternatives to debt securities.

(ii) "While structured products pay interest like debt securities, they often exhibit profit and loss potential more like an option contract."

(iii) Where there is a risk of losing all or a substantial portion of the principal in return for above-market rate current income, the volatility of the reference asset upon which total return of the investment depends is an important factor in determining suitability.

C. High Yield Securities – FINRA Reminds Firms of Their Sales Practice Obligations with Regard to the Sale of Securities in a High Yield Environment

FINRA Regulatory Notice 08-81 (December 2008) was intended to reiterate to firms their obligations in connection with the sale of certain securities during periods in which yields reached unusually high levels.

Specifically, FINRA's Notice was intended to remind firms of their obligation to balance the discussion of yield with an appropriate description of the features of bonds, bond funds, structured products, and non-conventional investments and the risks associated with such transactions.

D. Non-Traditional ETFs – FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds

In Regulatory Notice 09-31 (June 2009), FINRA provided information concerning its views of firms' sales practice obligations that arise in connection with investments in leveraged and inverse ETFs.

In particular, the Notice stated that recommendations must be suitable and based upon a complete understanding of the terms and features of the recommended product. In addition, FINRA cautioned that sales materials relating to leveraged and inverse ETFs must fairly and accurately describe the products. FINRA also emphasized that firms must train their brokers about the terms, features and risks of ETFs. As it relates to leveraged and inverse ETFs, FINRA pointed out that the training should focus on the need to understand an investor's time horizons and the impact of time and volatility on the investment's performance. The Notice stated that firms are obligated to have adequate supervisory procedures in place for these products. Specifically, FINRA noted that firms that permit brokers to

recommend leveraged and inverse ETFs must have written supervisory procedures that require:

(i) an appropriate reasonable-basis suitability analysis be conducted;

(ii) brokers to conduct an appropriate customer-specific suitability review;

(iii) sales materials be accurate and balanced presentations; and

(iv) relevant FINRA and SEC rules be adhered to.

In May 2012, FINRA sanctioned four firms in connection with their sales of leveraged and inverse ETFs. Those cases are discussed below.

E. Reverse Convertibles – FINRA Reminds Firms of Their Sales Practice Obligations With Reverse Exchangeable Securities

In Regulatory Notice 10-09 (February 2010), FINRA noted that reverse convertibles had become popular structured products with retail investors because of the high yields offered by such securities. FINRA, however, pointed out that these investments are complex and that investors and brokers may find it difficult to understand their terms, features and risks.

FINRA issued its Regulatory Notice to advise firms of their obligations regarding communications with the public, suitability, supervision and training.

On the same day that FINRA issued this Regulatory Notice, it announced an enforcement action against H&R Block Financial Advisors regarding alleged inadequate supervision of reverse convertible notes sales; FINRA also suspended and fined a broker for unsuitable sales. This case is further described below.

F. FINRA's Guidance on Firm Heightened Supervisory Obligations for Complex Products[2]

FINRA Regulatory Notice 12-03 on supervision of complex products raises complicated issues for firms that offer a broadening universe of new and changing products to retail investors, especially as firms are implementing revised compliance programs to meet FINRA's suitability requirements.[3] The Notice attempts to pull together, but expands on, a succession of previous Regulatory Notices outlining best practices with hedge funds and other non-conventional investments, equity-indexed annuities, structured products, leveraged and inverse

[2] This description of Regulatory Notice 12-03 was drafted by Mary M. Dunbar of Morgan, Lewis & Bockius LLP.

[3] *See* FINRA Rule 2111, effective July 9, 2012.

exchange-traded funds, principal protected notes, reverse convertibles, commodity futures-linked securities, new products, and Regulation D offerings.

FINRA contends that a consistent theme in its previous guidance is that the complexity of a product often necessitates more scrutiny and supervision by a firm. While the Notice provides guidance about the characteristics of many complex products, it does not define what a "complex product" is or provide an exhaustive list of features that might render a product "complex." As such, firms could be faced with the challenge of determining which products should – by virtue of their characteristics or changes in their characteristics – be deemed "complex" and potentially subject to the heightened supervision recommended by FINRA.

The Notice professes to expand on the guidance for new products in Regulatory Notice 05-26, which recommended a rigorous vetting process, including consideration of whether less complex products could achieve the same objectives for investors, and a post-approval follow-up and review. In addition, the Notice encourages firms to consider prohibiting their sales force from recommending some complex products, particularly those with embedded options or derivatives, to retail investors whose accounts have not been approved for options trading, a recommendation that previously was limited to certain structured products and principal-protected notes.[4] Alternatively, FINRA states that firms should develop other comparable procedures to ensure that their sales force does not solicit retail customers for whom complex products are unsuitable and be prepared to demonstrate the basis for allowing their sales force to recommend complex products to retail investors with accounts not approved for options trading. This expansion of FINRA's previous guidance to additional products and customers could impose substantial supervisory responsibilities on firms.

1. Characteristics of Complex Products

According to FINRA, any product with multiple features that affect its investment returns differently under various scenarios is potentially complex, particularly if an average retail investor could not reasonably be expected to discern such features and how they interact to produce an investment return. FINRA provides a non-exhaustive list of examples:

- Asset-backed securities that are secured by a pool of collateral such as mortgages, payments from consumer credit cards or future royalty payments on popular music;
- Unlisted REITs;
- Products with an embedded derivative component;

[4] *See* Notice to Members 05-59 and Regulatory Notice 09-73

- Products with contingencies in gains or losses, particularly those that depend on multiple mechanisms, such as the simultaneous occurrence of several conditions across different asset classes;
- Structured notes with "worst-of" features, which provide payoffs that depend on the worst performing reference index in a pre-specified group;
- Investments tied to the performance of markets that may not be well understood by many investors;
- Products with principal protection that is conditional or partial, or that can be withdrawn by the product sponsor on the occurrence of certain events;
- Product structures that can lead to performance that is significantly different from what an investor may expect, such as products with leveraged returns that are reset daily; and
- Products with complicated limits or formulas for the calculation of investor gains.

FINRA cautions that products that do not possess the characteristics described above may nevertheless require heightened supervision due to the risks they present. For example, products that have not been the subject of previous Regulatory Notices, such as certificates of deposit tied to derivatives, may be subject to heightened supervision.

2. Heightened Supervision

FINRA discusses four areas of supervisory and compliance procedures that may assist firms in assessing their controls over complex products: approval of the sales of complex products, post-approval review, training of registered representatives, and customer considerations and communications.

(i) Approval of the Sale of Complex Products

FINRA states that firms should have formal written procedures to ensure that their registered representatives do not recommend a complex product to a retail investor before it has been thoroughly vetted. According to FINRA, those procedures should ensure that "the right questions are answered before a complex product is recommended to retail investors." FINRA believes that these questions, which are substantially similar to the questions set forth in Notice 05-26 for new products, should include the following:

- For whom is this product intended? Is the product proposed for limited or general retail distribution, and, if limited, how will it be controlled?
- Conversely, to whom should this product not be offered?
- What is the product's investment objective and is that investment objective reasonable in relation to the product's characteristics?
- How does the product add to or improve the firm's current offerings?

- Can less complex products achieve the objectives of the product?
- What assumptions underlie the product, and how sound are they?
- How is the product expected to perform in a "wide variety of market or economic scenarios?" What market or performance factors determine the investor's return? Under what scenarios would principal protection, enhanced yield, or other presumed benefits not occur?
- What are the risks for investors?
- If the product was designed mainly to generate yield, does the yield justify the risks to principal?
- How will the firm and registered representatives be compensated for offering the product? Will the offering of the product create any conflicts of interest between the customer and any part of the firm or its affiliates? If so, how will those conflicts be addressed?
- Does the product present any novel legal, tax, market, investment or credit risks?
- Does the product's complexity impair understanding and transparency of the product?
- How does this complexity affect suitability considerations or the training requirements associated with the product?
- How liquid is the product? Is there an active secondary market for the product?

(ii) Post-Approval Review

FINRA recommends that firms consider developing procedures to monitor how complex products perform after the firm approves them. While the Notice does not set forth a specific post-approval review process, such a process was previously described in Notice 05-26 for new products, which recommended that firms:

- Track and monitor customer complaints and grievances relating to products;
- Reassess the firm's training needs regarding a product on a continuing basis;
- Establish procedures to monitor, on an ongoing basis, firm-wide compliance with any terms or conditions that have been placed on the sale of the product;
- Periodically reassess the suitability of the product; and
- Review any product before lifting any restrictions or conditions on the sale of the product.

(iii) Training of Registered Representatives

According to FINRA, registered representatives should be adequately trained to understand not only the manner in which a complex product is expected to perform in "normal market conditions," but the risks associated with the product. In particular, FINRA believes that registered representatives who recommend complex products must understand the features and risks associated with those products. For example, FINRA indicated that registered representatives should understand such features as the characteristics of any reference asset (including its historic performance and volatility and its correlation with specific asset classes), any interrelationship between multiple reference assets, the likelihood that the complex product may be called by the issuer, and the extent and limitations of any principal protection. In addition, FINRA goes so far as to say that registered representatives should be "competent to develop a payoff diagram" of a structured product to facilitate their analysis of the product's embedded features and "recognize that such a product typically can be decomposed into bond and derivative parts." This suggestion places an added focus on internal sales material developed to assist registered representatives in selling products, which has become a large focus in both SEC and FINRA investigations and enforcement matters.

(iv) Customer Considerations and Communications and Use of Options Account Approval Processes

(a) Consideration of a Customer's Financial Sophistication

In recommending complex products, FINRA states that firms "are encouraged to adopt the approach mandated for options trading accounts, which requires that a registered representative have 'a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the' complex product." FINRA further states that firms also should consider barring their sales force from recommending the purchase of some complex products (particularly those with embedded options or derivatives) to retail investors not approved for options trading and consider mandating some level of supervision by "a specially qualified supervisor"[5] of these recommended transactions. FINRA notes that firms that permit the recommendation of complex products to retail investors not approved for options trading "should develop other comparable procedures designed to ensure that their sales force does not solicit retail customers for whom complex products are unsuitable." As such, FINRA appears to want firms to gather additional information from clients to support their recommendations, and, while information commonly elicited as part of an options account approval

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[5] The Notice does not define or describe what the special qualifications would be.

process may be relevant, given the diversity of the complex products cataloged by FINRA, firms will have to decide on a product-by-product or characteristic-by-characteristic basis whether additional information might be prudent. FINRA previously recommended using an option account standard for suitability in Notice 05-59, with respect to certain structured products, and Notice 09-73, with respect to certain to principal-protected notes.

(b) Customer Communications

FINRA recommended that a registered representative who intends to recommend a complex product should discuss with the retail customer the features of the product, how it is expected to perform under different market conditions, the risks and the possible benefits, and the costs of the product. In particular, according to FINRA, the registered representative should discuss the scenarios in which the product may perform poorly. According to FINRA, the registered representative should communicate in a manner "reasonably likely to facilitate the customer's understanding" and "consider whether, after this discussion, the retail customer seems to understand the basic features of the product, such as the fundamental payout structure and the nature of underlying collateral or a reference index or asset."

(c) Consideration of Whether Less Complex or Costly Products Could Achieve the Same Objectives

Finally, FINRA states that registered representatives should consider whether less complex or costly products could achieve the same objectives for their customers. This statement paralleled FINRA's recommendation in Notice 05-26 that, in approving a new product, a firm should consider whether less costly, complex, or risky products could achieve the same objectives.

3. Practical Approaches for Firms

In developing a response to the Notice, firms may wish to consider the following:

(i) Review of Product Approval Procedures

Firms may want to consider developing internal guidelines to address the identification of complex products in accordance with the suggestions in Regulatory Notice 12-03 and revisit the process and criteria by which their new product committees assess new products and any post-approval review is carried out.

(ii) Review of Products in the Field

Firms may want to consider reviewing whether products already released to the field should be deemed complex products and should be reevaluated in light of any additional procedures the firm adopts for complex products.

(iii) Training and Supervision

Firms may want to review whether their register representative training materials and program adequately address complex products and consider whether to designate a "specially qualified supervisor" to approve certain complex product transactions. Firms also may want to consider including complex products in the internal controls reviews undertaken under NASD Rule 3012 and FINRA Rule 3130.

(iv) Customer Communications

Firms may want to review their advertising, sales literature, and other communications with customers regarding complex products and consider using more broad-based disclosures about complex products generally.

(v) Account Opening and Documentation

Firms may want to consider whether to adopt the option account approach suggested by FINRA or, alternatively, develop and document the basis for alternative comparable procedures. Firms also may want to consider adding specific provisions in their customer agreements pertaining to special risks posed by certain products (e.g. options and structured products).

G. FINRA's FAQs and Other Guidance Relating to Its Recently Revised Suitability Rule

In Regulatory Notice 12-25 (May 2012), FINRA provided additional guidance concerning FINRA Rule 2111 (Suitability). The rule requires a firm or associated person to "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile."

Although the rule does not explicitly require documenting compliance with suitability obligations except under certain limited circumstances, the Notice stated, "[T]he recommendation of a complex and/or potentially risky security or investment strategy involving a security or securities usually would require documentation."

For "hold" recommendations, the Notice stated that FINRA recommended that firms may want to focus on securities that could be viewed as having a shorter-term investment component; that have a periodic reset; that are particularly susceptible to market condition changes; or that are potentially risky or problematic to hold at the time the recommendations are made. Examples given included leveraged ETFs and mortgage REITs, among others.

In Regulatory Notice 13-31 (September 2013), FINRA supplemented the 12-25 Notice by reminding firms that although Rule 2111 did not impose explicit

documentation requirements, that the type or form of documentation that may be needed was "dependent on the facts and circumstances of the investment strategy or hold recommendation, including the complexity and risks associated with the security or investment strategy at the time of the recommendation."

III. EXAMINATION PRIORITIES

In its March 9, 2009 letter outlining new and existing areas of importance to its examination program, FINRA described the staff's focus on alternative investments in light of the then-current market conditions. Among other things, the letter describes the suitability, disclosure, and supervisory obligations imposed on firms recommending structured products, high-yield bonds and bond funds, and other alternative investments. Of note, FINRA indicated that there was an increase in firm applications for firms to engage in retail foreign currency exchange business. The staff observed that this business is "particularly risky for individual investors, and has generated problems from abusive sales practices to the financial failure of retail forex merchants." Accordingly, FINRA examiners will closely review firms already engaged in or seeking to conduct retail forex business.

On March 1, 2010 FINRA published its annual examination priorities letter. In doing so, FINRA again took the opportunity to remind firms about their obligations when creating or selling new products. Specifically, FINRA pointed out the growth in the sales of principal-protected notes and reverse convertible notes to retail investors. The letter reiterates firms' suitability, disclosure, supervisory, surveillance and training obligations.

As in prior years, the 2011 FINRA Annual Regulatory and Examination Priorities Letter highlighted several issues regarding complex and structured products. Specifically, FINRA stated that it was "focusing on firms that offer structured products and certain riskier asset-backed securities to retail investors." Among other products mentioned in the Letter, FINRA noted CMOs, non-traded REITs and exchange-traded funds and notes. FINRA emphasized its view on the importance of training financial advisers, suitability and supervision.

In November 2011, FINRA's Advertising Regulation Department and the Department of Enforcement Case Development Team announced that they were conducting an inquiry regarding spread-based structured products. The Staff requested extensive documents and information from firms including materials relating to advertisements, suitability procedures, written supervisory protocols, risk disclosure documents and customer complaints.

On January 31, 2012, FINRA again included the sale of structured, esoteric and complex products in its annual priorities letter. That year, FINRA stated that it was specifically concerned with yield chasing, liquidity, cash flow characteristics, the transparency of cash flows and the financial condition of certain securities offered to retail investors. Products included in the 2012 letter included residential mortgage-backed securities and commercial mortgage-backed

securities, non-traded REITs, complex exchange-traded products and structured products. Among other areas identified by FINRA were disclosures, fees, suitability, training and supervision.

On September 27, 2012, FINRA Chairman and Chief Executive Officer, Richard Ketchum, defined a complex product as the following: "A product might be considered complex if the average retail investor probably will not understand how its features will interact under different market conditions, and how that interaction may affect potential risk and return." He emphasized that firms must supervise the distribution of complex products to retail investors "at every stage"—ensuring that products are vetted, representatives are trained and supervised, and risks are disclosed in a way that the average investor could understand.[6] On the same day, former FINRA Executive Vice President of Member Regulation Sales Practice and current Executive Vice President of Regulatory Operations, Susan F. Axelrod, also emphasized several themes including the necessity for a new product vetting process; supervisory procedures that include clear and specific guidelines on how brokers and their supervisors should assess suitability of complex products recommendations; firm training programs; and quick adjustment of supervisory systems and training as needed or, in some cases, the limitation or elimination of the sale of complex products. [7]

On October 24, 2012, Ms. Axelrod noted that FINRA examiners had found common themes among examinations involving the improper sale and supervision of complex products including failures to take a proactive approach to vetting the product, failure to develop adequate supervisory procedures, and insufficient broker training programs. In addition, FINRA found that brokers were not effectively considering whether clients understood the risk the complex product posed and whether the level of risk was appropriate based on the client's profile.[8]

In its 2013 priority letter, FINRA highlighted that in light of FINRA's recently revised suitability rule, it was particularly concerned about firms' and registered representatives' full understanding of complex or high-yield products, potential failures to adequately explain the risk-versus-return profile of certain products, as well as the potential for a disconnect between customer expectations and risk tolerances. FINRA gave a non-exhaustive list of complex products that, in its view, have the potential to be unsuitable or otherwise problematic for retail investors based on their underlying market, credit and liquidity risk characteristics including: business development companies (BDCs), leveraged loan products, commercial mortgage-backed securities, high-yield debt instruments, structured products, exchanged-traded funds and notes, non-traded REITs, closed-end funds,

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[6] *See* Richard G. Ketchum, Chairman and Chief Executive Officer, FINRA, Keynote Address at the SIFMA Complex Product Forum (Sept. 27, 2012).

[7] *See* Susan F. Axelrod, Executive Vice President of Member Regulation, Sales Practices & Exams, FINRA, Address at SIFMA Complex Product Forum (Sept. 27, 2012).

[8] *See* Susan F. Axelrod, Executive Vice President of Member Regulation, Sales Practices & Exams, FINRA, Address at PLI Seminar on Broker-Dealer Regulation and Enforcement 2012 (October 24, 2012).

municipal securities, and variable annuities. FINRA stated that its examiners would focus on the suitability of recommendations, the brokers' level of product-specific knowledge, the level of due diligence in assessing risk tolerance and liquidity needs of the customer when making investment recommendations, the manner in which material risk exposures were disclosed to customers, and the impact on broker compensation associated with competing investment alternatives.

On January 2, 2014, FINRA again expressed concern about the suitability of recommendations to retail investors for complex products in its annual priorities letter. Noting the proliferation of complex products recommended to retail investors, FINRA reported that it intended to focus its examinations on the manner in which firms disclosed the material risks to investors and the policies and procedures surrounding those disclosures. Further, examiners would include a review of the training given to retail-facing brokers to determine whether they understand the products they recommend so they can have proactive conversations about product-specific risks with their customers. Like in 2013, FINRA highlighted the following non-exhaustive list of products on which FINRA intended to focus its examinations: complex structured products, private REITs, frontier funds, and interest rate sensitive securities including mortgage-backed securities, long duration bond funds, long duration bond ETFs, long duration corporates (particularly zero coupon or bullet bonds), emerging market debt, municipal securities, and baby bonds.

IV. ENFORCEMENT DEVELOPMENTS

In addition to the foregoing, complex and/or structured products sales to retail customers have also been the focus of various enforcement efforts over the last four years.

A. SEC Enforcement Developments

In early 2009, the new Director of Enforcement at the SEC, Robert Khuzami, announced the formation of five specialized units. In an August 5, 2009 speech, Mr. Khuzami laid out his plans for a Structured and New Products Unit:

> The Structured and New Products Unit will focus on complex derivatives and financial products, including CDS, CDOs and securitized products. These are huge markets, with outstanding notional amounts that at one time came close to the market capitalization of all publicly traded companies in the world. They are also opaque markets due to the complexity of the products, the limited availability of trading information and the prevalence of private offerings. This lack of transparency has become fertile ground for abuse and misconduct, and staying on top of these markets, and whatever new products are next devised, requires specialized knowledge and commitment.

Recent SEC cases in the retail area include the following.[9]

1. *In the Matter of David G. Brouwer*, Admin. Proc. File No. 3-14516 (Aug. 26, 2011)

   The SEC filed a settled administrative proceeding against David G. Brouwer, a former registered representative associated with broker-dealer and investment adviser Great American Advisors, Inc.

   The order alleges that Brouwer made material representations about and failed to disclose certain material risks associated with equity-linked notes that he recommended as investments to certain customers in 2007 and 2008. The order further alleges that Brouwer's recommendation of equity-linked notes to at least two of his customers was unsuitable based on their investment objectives and stated risk tolerance.

   Brouwer is charged with telling customers that the equity-linked notes, which were structured notes in which there was a derivatives exposure to the note holder due to the reverse convertible nature of the note, were safe when in fact there was the possibility that the notes would convert to securities at a value less than the invested principal. Brouwer failed to adequately disclose this risk to the investors. According to the SEC, Brouwer committed fraud in this case.

   Brouwer consented to the entry of a cease-and-desist order and the payment of $33,000 in disgorgement plus prejudgment interest and a civil fine of the same amount. Brouwer was also barred from the industry.

2. *SEC v. Brookstreet Securities Corp. and Stanley C. Brooks*, SA 8:09-cv-1431-DOC (C.D. Cal.) (March 1, 2012)

   In February 2012, the SEC concluded one of its first financial crisis cases when it obtained summary judgment against Brookstreet Securities Corp. ("Brookstreet") and its former President and CEO, Stanley Brooks ("Brooks"). The SEC had charged Brookstreet and Brooks in December 2009 with fraud for systematically selling risky CMOs to retail customers. Those customers, who at Brookstreet's recommendation used margin to leverage their CMO investments, lost almost their entire portfolios in 2007, when the prices for these CMOs plummeted.

   The SEC alleged that Brooks and Brookstreet created a program through which Brookstreet's registered representatives sold risky CMOs to, among others, seniors and retirees. Brookstreet frequently sold the CMOs to IRA accountholders and to customers who listed "preservation of capital" as

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9 The summaries of these cases are taken from the "Year in Review" publications issued by Morgan Lewis. These reports are available at morganlewis.com.

their investment objective. The SEC further alleged that Brookstreet and Brooks continued to promote and sell the CMOs even after Brooks received numerous warnings that the CMOs were dangerous investments that could become worthless overnight. According to the SEC's December 2009 complaint, approximately 90% of these CMOs were inverse floaters, interest-only and inverse interest-only bonds, which are among the riskiest types of CMOs. Indeed, Brooks had received warnings from Brookstreet's compliance department and other traders that the CMOs were too risky for retail investors.

On February 23, 2012 the Court entered an order granting summary judgment in favor of the SEC, finding Brookstreet and Brooks liable for securities fraud, and ordering them to pay a penalty of $10,010,000 and Brooks to pay disgorgement of $110,713.31.

3. *In the Matter of Wells Fargo Brokerage Services LLC n/k/a Wells Fargo Securities, LLC and Shawn Patrick McMurtry*, Admin Proc. File No. 3-14982 (Aug. 14, 2012)

The SEC filed a settled case against Wells Fargo and a former vice president alleging that they sold investments tied to mortgage-backed securities without completely understanding the complexity of the securities or disclosing their risks to investors.[10]

The SEC alleged that for eight months in 2007 the firm and its brokers made recommendations to customers to purchase asset-backed commercial paper structured with high-risk mortgage-backed securities and collateralized debt obligations to customers without reviewing the private placement memoranda of the issuers of those securities. Rather, the firm and its representatives relied almost exclusively on the credit ratings of the products. The firm also did not establish procedures to confirm that its personnel reviewed and understood the nature and risks of these securities. The SEC also alleged that Wells Fargo and its registered representatives failed to have a reasonable basis for its recommendations to customers. The former vice president, Shawn McMurtry, allegedly made improper sales of these securities by exercising discretionary authority in violation of the firm's policy and selecting the particular issuer to be purchased by one customer.

Wells Fargo was fined $6.5 million and agreed to pay $65,000 in disgorgement and about $16,000 in prejudgment interest. McMurtry was suspended for six months and fined $25,000.

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[10] Although the customers involved in this case were not individuals, but rather municipalities, non-profit institutions and others, this matter is nevertheless instructive.

B. FINRA Enforcement Developments

Recent FINRA cases in the retail area include the following:

1. *Brian Berkowicz* (July 22, 2008), *Cindy Schwartz* (July 24, 2008), and *John Webberly* (June 16, 2008)

   Three SAMCO Financial Services, Inc. brokers settled FINRA actions in connection with misconduct in marketing and sales of Collateralized Mortgage Obligations to retail customers.

   FINRA alleged that between June 2004 and September 2006, Berkowicz, Schwartz, and Webberly recommended inverse floaters to non-sophisticated retail investors for whom the securities were not suitable. As a result of these recommendations, nine clients collectively lost approximately $535,000.

   FINRA also alleged that the brokers allowed the SAMCO head trader, who was also their supervisor, to exercise discretion to purchase CMOs in the clients' accounts.

   Berkowicz and Schwartz each consented to be barred from the industry. Webberly consented to a two-year suspension and to assist FINRA in its ongoing prosecution of matters regarding sales of CMOs at the SAMCO Financial branch office involved in the case.

   This case reflected FINRA's first enforcement action involving allegations of unsuitable recommendations of mortgage-backed securities to retail clients.

2. *H&R Block Financial Advisors, Inc.* ("H&R Block") *and Andrew MacGill* (Feb. 16, 2010)

   FINRA settled a matter with H&R Block in which it alleged that the firm failed to establish adequate supervisory systems and written procedures for supervising retail sales of reverse convertible notes ("RCNs").

   An RCN is a structured product that consists of a high-yield, short-term note of an issuer and a put option that is linked to the performance of a "linked" asset. Upon maturity of an RCN, the investor receives either the full principal of his investment plus interest, or a predetermined number of shares of the linked asset. In addition to the ordinary fixed income product risks, RCNs carry the additional risk of the underlying linked asset, which, depending on performance, could be worth less than the principal investment.

   FINRA alleged that, between January 2004 and December 2007, H&R Block sold RCNs without having in place an adequate surveillance system

to monitor for overconcentration in RCNs. As a result, the firm failed to detect and address such overconcentrations in customer accounts.

FINRA alleged that H&R Block failed to provide guidance to its supervising managers to enable them to effectively assess suitability related to RCNs.

FINRA alleged that, between May 2007 and November 2007, H&R Block broker Andrew MacGill made unsuitable sales of RCNs to a retired couple who invested nearly 40 percent of their total liquid net worth in nine RCNs.

H&R Block consented to a censure and to pay a $200,000 fine and $75,000 in restitution.

MacGill consented to a fine and disgorgement totaling $12,023 and a 15-day suspension from associating with any FINRA member firm in any capacity.

3. *In the Matter of UBS Financial Services, Inc.* ("UBSFS") (Apr. 11, 2011)

FINRA alleged that between March 2008 and June 2008, UBSFS made statements and omissions that effectively misled some investors regarding the "principal protection" feature of "100% Principal Protection Notes" ("PPNs") that Lehman Brothers Holdings Inc. issued prior to its September 2008 bankruptcy.

According to FINRA, some UBSFS financial advisors described the structured notes as principal-protected investments and failed to emphasize that the investments were unsecured obligations of Lehman Brothers subject to issuer credit risk.

FINRA alleged that UBSFS failed to establish an adequate supervisory system for the sale of these notes and failed to provide sufficient training and written supervisory policies and procedures, noting that some of the financial advisors did not understand the product.

FINRA also alleged that the firm did not adequately analyze the suitability of the sales of Lehman-issued PPNs to certain customers and created and used advertising about the PPNs that was effectively misleading to customers, particularly in light of the changes in the market after the takeover of Bear Stearns in early 2008.

UBSFS consented to a censure, a fine in the amount of $2.5 million, and customer restitution of $8.25 million.

4. *Santander Securities Corporation* ("Santander") (Apr. 12, 2011)

FINRA settled a matter with Santander in which it alleged unsuitable sales of reverse convertible securities to retail customers, inadequate supervision of sales of structured products, inadequate supervision of accounts funded with loans from its affiliated bank, and other violations related to the offering and sale of structured products.

According to FINRA, for most of the period from September 2007 to September 2008, the firm had no formal procedures for reviewing or approving structured products before offering them to customers. Instead, individual brokers evaluated the products, but received limited and inadequate training, guidance and supervision related to structured products, including their risks and their suitability for individual clients. During the relevant period, Santander customers invested $130 million in reverse convertibles and the firm earned more than $1.7 million in commissions.

According to FINRA, the firm also failed adequately to follow up on compliance reports of accounts over-concentrated with positions in reverse convertibles, including identification of 108 accounts holding more than 20% of the accounts' value in a single reverse convertible product, accounting for approximately $17.8 million in reverse convertibles.

FINRA also found that the firm actively solicited account holders to borrow money from its banking affiliate using securities pledged in their brokerage accounts as collateral, and some brokers then assisted clients in using the borrowed funds to buy reverse convertibles, even though the clients did not understand the products or risks. When the stock market declined precipitously in 2008, some clients were left with large debts to the bank.

FINRA alleged other violations by Santander, including: (i) failing to comply with certain public offering and corporate financing requirements; (ii) inserting confidentiality provisions inconsistent with FINRA guidance in five customer settlement agreements; and (iii) filing six Forms U4 or U5 for brokers that inaccurately reported broker contributions to reverse convertibles settlements when no such contributions were made.

Santander consented to a censure, a fine of $2 million and an undertaking to: (i) review its written policies and procedures, training and available tools in the areas of product suitability, sales supervision and intrastate offerings; (ii) establish written policies and procedures for the development and vetting of new products; and (iii) train personnel with responsibility for FINRA regulatory filings.

In setting the sanction, FINRA noted that Santander had provided over $7 million in restitution to customers.

5. *Chase Investment Services Corp.* ("CISC") (Nov. 15, 2011)

FINRA settled a matter with CISC in which it alleged that, between January 1, 2007 and December 31, 2008, CISC made 257 unsuitable recommendations of two particular higher-risk unit investment trusts ("UITs"), which contained a high percentage of "junk" bonds, to customers with little or no investment experience and conservative risk tolerances. CISC's customers made 3,582 purchases of these two UITs, which represented a value of $141 million, generated over $2.8 million in commissions and resulted in losses of approximately $1.435 million.

According to FINRA, CISC provided no formal UIT training to its registered representatives. Instead, most of the information that the registered representatives obtained and utilized came directly from the UIT wholesalers' and sponsors' websites. CISC's supervisory procedures also failed to provide reasonable guidance regarding determining the suitability of UIT transactions.

Additionally, in certain instances CISC did not require verification of the information within customer applications, including suitability information, which caused actual customer profiles to not match the information in the application and led to the approval of unsuitable UIT transactions. Also, in several instances registered representatives changed customer risk tolerance profiles or investment objectives to be consistent with the suitability requirements of a particular UIT, but these changes were not verified to ensure that they were accurate.

FINRA also alleged that CISC failed to have a supervisory system reasonably designed to ensure that all UIT transactions received principal approval. Specifically, two types of UIT transactions that did not receive principal review accounted for over 11,000 separate UIT transactions and included 27 unsuitable purchases.

FINRA also alleged that CISC failed to comply with its procedures that required review of a UIT product approximately six months after it was approved and launched. Specifically, CISC approved seven new UITs in October 2007 but did not conduct a post-launch review until July 2008.

FINRA also alleged that CISC made unsuitable floating rate fund recommendations to customers who had conservative risk tolerances and/or were seeking preservation of principal, resulting in losses of approximately $736,000.

According to FINRA, CISC did not provide any formal training to registered representatives regarding floating rate funds. Specifically, CISC failed to adequately train its registered representatives regarding credit and liquidity risk of floating rate funds and regarding the customers for whom floating rate funds would be suitable.

FINRA also alleged that CISC failed to implement its internal policy that required all sales of floating rate funds to be reviewed to determine whether they exceeded 10% of the client's investable assets, in which case the registered representative was required to cancel the trade, obtain an internal waiver from the policy, adjust the trade to be within the policy's acceptable standards or obtain an executed disclosure form from the customer.

According to FINRA, in addition to failing to follow up on floating rate fund trades that exceeded the percentage guideline, registered representatives also updated customers' risk tolerances on their suitability profiles without any further verification with the customer that the revised information was accurate.

FINRA also alleged that, between January 2, 2007 and July 31, 2008, WaMu Investments, Inc. ("WaMu"), which merged into CISC in July 2009, made unsuitable floating rate fund recommendations to customers and failed to reasonably supervise the sale of floating rate funds to customers.

According to FINRA, WaMu made recommendations to certain customers without reasonable grounds for believing that the floating rate funds were suitable for the customers, who suffered approximately $180,000 in losses. Additionally, WaMu did not provide any formal training to registered representatives regarding floating rate funds.

CISC consented to a censure, a fine of $1.7 million, and restitution of approximately $1.92 million to certain customers.

6. *Wells Fargo Investments, LLC* ("WFI") (Dec. 15, 2011)

FINRA alleged that between January 2006 and July 2008, WFI, through one of its registered representatives, Alfred Chi Chen, effected hundreds of unsuitable reverse convertible transactions for 21 customers, most of whom were elderly, with 15 over 80 years old, including four over 90 years old. As of May 2008, each of the 21 customer accounts held over 50% of investible assets in reverse convertibles.

In addition, FINRA alleged that WFI failed to provide certain eligible UIT customers with breakpoint and rollover and exchange discounts to which they were entitled.

According to FINRA, WFI failed to reasonably supervise Mr. Chen and had deficiencies in its supervisory system and procedures relating to reverse convertibles from June 2006 through December 2009 and relating to UITs from January 2004 through December 2009.

WFI consented to a censure, a fine of $2 million and to provide remediation to certain customers who purchased reverse convertibles and UITs.

FINRA also filed a complaint against Mr. Chen for recommending and selling the unsuitable reverse convertibles and for making unauthorized trades in several customer accounts, including accounts of deceased customers.

7. *Wells Investment Securities, Inc.* ("Wells") (Nov. 22, 2011)

FINRA settled a matter with Wells in which it alleged that between May 31, 2007 and September 30, 2009 (the "relevant period"), the Firm, acting as dealer manager, engaged in certain violations related to the marketing of a public offering of a non-traded Timberland Real Estate Investment Trust ("TREIT"), and failed to implement adequate procedures to protect sensitive and proprietary customer information.

TREIT was unlike other REITs in that it made only one type of property acquisition, could not make distributions, and did not allow redemptions. These differences prevented TREIT from qualifying for REIT favorable tax election in the initial stages.

FINRA alleged that during the relevant period Wells reviewed, approved and distributed over one hundred communications which did not provide an adequate basis for evaluating the facts regarding TREIT and/or contained misleading, unwarranted, or exaggerated statements. Specifically, materials allegedly failed to disclose the implications of TREIT's non-REIT status and/or suggested that TREIT was a REIT at a time when in fact it had not qualified to be one. The materials also did not disclose the lack of diversification of the investment and the inability to make distributions and redemptions.

FINRA also alleged that Wells had an inadequate supervisory system of educating employees such that they understood the specific features of the investments for which marketing they reviewed.

Finally, FINRA alleged that the firm did not have policies and procedures reasonably designed to protect confidential customer and propriety information as required under SEC Regulation S-P. For example, on one occasion, personal and confidential information of 37,864 customers, including social security numbers, investment data and account numbers, were placed at risk when a laptop containing that information was stolen from the car of an employee of a Wells affiliate. Wells had no procedures for laptop encryption and no requirement for encryption of all data on firm laptops.

Wells consented to a censure and a fine of $300,000.

In setting the sanctions, FINRA considered the firm's proactive steps taken after theft of a laptop containing sensitive information, including, undertaking an investigation, notification of affected customers, the attorneys general and other appropriate authorities in the relevant states, as well as credit reporting agencies.

8. *Morgan Stanley & Co. LLC* (“Morgan Stanley”) (Jan. 5, 2012)

FINRA alleged that from September 2006 to August 2008, Morgan Stanley failed to have a reasonable supervisory system and procedures in place to notify supervisors whether structured product purchases complied with Morgan Stanley’s internal guidelines related to concentration and minimum net worth.

FINRA noted that Morgan Stanley’s customers effected approximately 224,000 structured products purchases, of which more than 28,000 were in net amounts that exceeded 25% of the customers’ disclosed liquid net worth and more than 2,600 were effected by customers with a stated net worth that was less than the $100,000 minimum.

FINRA alleged that, after reviewing a sample of structured product purchases, it uncovered 14 unsuitable recommendations for eight customers that were inconsistent with the customers’ financial situation and investment objectives.

In addition, FINRA alleged that Morgan Stanley’s daily transaction reports for structured product purchases did not reflect evidence that supervisory action was taken in connection with the specific nonconforming purchases.

Morgan Stanley consented to a censure and a fine of $600,000. The decision noted that the firm had previously entered into settlements with the eight customers relating to the 14 transactions and paid those customers $329,000.

9. *Citigroup Global Markets Inc.* (“CGMI”) (May 1, 2012); *Morgan Stanley & Co. LLC* (“Morgan Stanley”) (May 1, 2012); *UBS Financial Services Inc.* (“UBS”) (May 1, 2012) *and Wells Fargo Advisors, LLC, Wells Fargo Advisors Financial Network, LLC and Wells Fargo Investments, LLC* (collectively, “Wells Fargo”) (May 1, 2012)

FINRA settled matters with CGMI, Morgan Stanley, UBS and Wells Fargo in which it alleged that from January 2008 through July 2009, the firms violated suitability and supervision rules in connection with the sale of leveraged, inverse, and inverse-leveraged ETFs (“Non-Traditional ETFs”).

Non-Traditional ETFs seek to deliver multiples and/or the inverse of the underlying index or benchmark that they track. According to FINRA, because these ETFs reset daily and are designed to achieve their stated objectives on a daily basis, investors were subject to the risk that the performance of these investments over longer periods would differ significantly from the underlying index or benchmark.

Certain customers of the four firms with conservative risk tolerance profiles and/or a primary investment objective of income held Non-Traditional ETFs for several months.

FINRA alleged that prior to June 2009, the firms failed to maintain and enforce a supervisory system tailored to address the unique features and risks of Non-Traditional ETFs and also failed to provide adequate training to registered representatives and supervisors regarding these features and risks. FINRA further alleged that the firms violated NASD and FINRA rules by allowing their registered representatives to recommend Non-Traditional ETFs without performing reasonable diligence to understand the risks and features associated with them.

FINRA noted that over the relevant period the firms' customers bought and sold the following levels of Non-Traditional ETFs: Wells Fargo – $9.9 billion, CGMI – $7.9 billion, then Morgan Stanley – $4.78 billion, and UBS – $4.5 billion.

The firms each consented to a censure, a fine and restitution. Specifically, the firms agreed to the following: (a) Wells Fargo – a fine of $2.1 million and restitution of $641,489; (b) CGMI – a fine of $2 million and restitution of $146,431; (c) Morgan Stanley – a fine of $1.75 million and restitution of $604,584; and (d) UBS – a fine of $1.5 million and restitution of $431,488.

10. *Merrill Lynch, Pierce, Fenner & Smith, Incorporated* (May 25, 2012)

In this case, FINRA alleged that for approximately three years Merrill Lynch failed to develop a reasonable supervisory system to identify for supervisors on an automated basis potentially unsuitable concentration levels in structured products contained in customer accounts. According to FINRA, between January 1, 2006 and March 1, 2009, Merrill Lynch customers engaged in about 650,000 structured product purchases; 50% of these transactions involved offerings issued by Merrill Lynch's parent company. Prior to March 1, 2009, Merrill Lynch did not have an exception report that specifically monitored for potentially unsuitable concentration levels in structured products in customer accounts.

Merrill Lynch was fined $450,000.

11. *Brookstone Securities, Inc.* ("Brookstone"), *Anthony Lee Turbeville, Christopher Dean Kline, and David William Locy* (Jun. 4, 2012)

In this contested action, a FINRA Hearing Panel ruled that from July 2005 through July 2007, Brookstone, through its CEO and one of its brokers, intentionally made fraudulent misrepresentations and omissions and made unsuitable recommendations to elderly and unsophisticated customers, ranging in age from 68 to 98 years old, regarding the risks associated with investing CMOs. The Hearing Panel also found that Brookstone, through its CEO, intentionally used misleading communications, and through its CCO failed to conduct any meaningful supervision of discretionary accounts.

The Hearing Panel found that the CEO and broker led customers to believe that the CMOs were government-guaranteed bonds that preserved capital and generated 10% to 15% returns and failed to tell its customers that CMOs are highly risky securities that are subject to dramatic changes in maturity, cash flow, and liquidity based on relatively minor changes in interest rates.

During the relevant time period, Brookstone made $492,500 in commissions on CMO bond transactions in the discretionary accounts of seven customers, while those same customers lost $1,620,100.

The Hearing Panel found that during the relevant period the CCO also was the supervisor of the CEO and the broker, and the CCO "should have been a line of defense" against the misconduct but instead failed to review the discretionary accounts or monitor the trading in them or respond to red flags concerning suitability. Under the firm's written supervisory procedures, the CCO also was required to contact discretionary account customers annually to determine their level of satisfaction, but failed to do so. As such, the Hearing Panel found that the CCO was as culpable as the CEO and broker.

The Hearing Panel censured and fined Brookstone $1 million and ordered full restitution to the customers of $1,620,100; of the restitution amount, $440,600 was imposed jointly and severally with the CEO and $1,179,500 was imposed jointly and severally with the broker. The Hearing Panel also (i) barred the CEO and broker from the securities industry, and (ii) barred the CCO from acting in a supervisory capacity, suspended him from acting in any capacity for two years, and fined him $25,000. In setting the sanction, the Hearing Panel noted that the firm had consented to a fine of $200,000 in 2011 for willful misrepresentations to customers, among other things.

12. *Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch")* (Aug. 29, 2012)

FINRA settled a matter with Merrill Lynch in which FINRA alleged that between October 2006 and February 2009, Merrill Lynch, through a former broker, recommended to at least 12 customers (all of whom were retired or unemployed and most of whom were elderly, conservative, and/or unsophisticated investors), 37 unsuitable short-term transactions in Closed-End Funds ("CEFs") and Unit Investment Trusts ("UITs"), which were generally intended as longer-term investments.

In addition, FINRA alleged that Merrill Lynch, through the former broker, recommended the unsuitable use of margin to finance seven customers' purchases and sales of securities, including the short-term trading of UITs and CEFs.

During this time, Merrill Lynch and the former broker earned approximately $47,000 in commissions and margin interest from the unsuitable short-term trading for these customers, during which time these customers lost over $430,000.

FINRA noted that one widowed customer in her eighties with a very conservative investment objective incurred $32,000 in losses and generated $4,800 in commissions on positions in CEFs and UITs, and a widower in his eighties who indicated an aversion to debt had a margin balance of $250,000, which was over one-third of his account's value, for which he was required to pay over $10,000 in margin interest.

FINRA alleged that Merrill Lynch failed to respond to exception reports or detect a pattern that suggested that the former broker was engaging in unsuitable short-term trading of CEFs and UITs and transactions on margin. FINRA also alleged that the firm did not speak with any of the 12 customers about the short-term trading or margin activity until they began complaining in April 2008.

Merrill Lynch consented to a censure and a $400,000 fine, disgorgement of approximately $47,000 in commissions, and an undertaking to pay approximately $130,000 in customer restitution for uncompensated losses.

13. *David Lerner Associates, Inc.* ("DLA")*, David Lerner* ("Lerner")*, and William Mason* ("Mason") (Oct. 22, 2012)

FINRA settled a matter with DLA, Lerner (the firm's founder, President and CEO), and Mason (the firm's head trader) in an action related to nonpublicly traded Apple REITs involving suitability and supervision violations. The settlement also consolidated numerous matters, including a municipal and CMO markup case, a pending enforcement investigation of more recent municipal and CMO markups, and 10 pending market

regulation matters involving municipal markups identified through surveillance reviews.

According to FINRA, DLA marketed and sold REITs without performing adequate due diligence, especially in light of certain red flags and DLA's role as sole underwriter, in violation of its suitability obligations.

FINRA also alleged that DLA provided performance figures for REITs that were misleading, failed to disclose material information and inaccurately mischaracterized information.

According to FINRA, DLA also gave seminar presentations to investors related to REITs that were not fair and balanced and omitted numerous facts and qualifications that caused the communications to be misleading. In addition, Lerner sent letters to DLA's customers to counter negative media attention directed at DLA, and these letters, which were "correspondence" under FINRA's rules, omitted material information, which caused them to be misleading. The letters also contained exaggerated, false and misleading statements regarding REITs.

FINRA also alleged that, at seminars, in seminar materials, and in letters to customers, DLA and Lerner made untrue representations of material fact or omissions of material fact regarding the prior performance, steady distribution rates, unchanging valuations, and prospects of REITs, and that this was done either with the intent to defraud investors or with recklessness, but were at least made negligently.

According to FINRA, DLA also charged excessive markups and markdowns and/or failed to meet its obligation to provide a fair and reasonable price to customers at the time of the transaction for thousands of municipal security transactions. FINRA also alleged that DLA charged excessive markups on hundreds of CMO transactions, which resulted in sales of CMOs to retail customers at prices that were not fair. Further, FINRA alleged that DLA failed to show the terms and conditions and the time of the receipt on the memorandum on 1,634 brokerage orders in municipal bonds.

DLA agreed to (i) a censure and fine of over $2.3 million; (ii) pay restitution of $12 million; (iii) provide certain written reports and documentation to FINRA; (iv) certain undertakings related to its advertising, sales literature and public appearances, including related to its internal policies and procedures and its supervisory structure as well as filing certain materials with FINRA's Advertising Regulation Department; and (v) retain, and pay for, independent consultants to conduct certain reviews.

Lerner agreed to (i) a suspension from association with any FINRA member firm in any capacity for a period of one year and, thereafter, to a

suspension from acting in any principal capacity with any FINRA member firm for two years; (ii) to requalify for the Series 7 and 24 licenses prior to reassociating with any FINRA member firms as a General Securities Representative or General Securities Principal, respectively; and (iii) a fine of $250,000 for the purpose of restitution to DLA's customers.

Separately, Mason, DLA's Head Trader, was censured and fined $200,000 and suspended for six months from the securities industry for his role in charging excessive municipal and CMO markups. Those sanctions resolved a May 2011 complaint (amended in December 2011) as well as an earlier action in which a FINRA hearing panel found that the firm and Mason charged excessive municipal and CMO markups.

14. *Wells Fargo Advisors, LLC ("Wells Fargo"), as successor in interest to Wells Fargo Investments, LLC and Merrill Lynch, Fenner & Smith Inc., as successor in interest to Banc of America Investment Services, Inc. ("BAI") (collectively the "firms")* (June 4, 2013)

FINRA settled separate matters with Wells Fargo and BAI in which it alleged that the firms made unsuitable recommendations of floating-rate bank loan funds, failed to train their sales forces regarding characteristics of the funds and failed to reasonably supervise sales of the funds.

FINRA stated that between January 1, 2007 and December 31, 2008, the firms' respective registered representatives recommended floating-rate bank loan funds to customers without conducting adequate suitability assessments. In particular, representatives recommended the funds, which are subject to high credit risk and can be illiquid, to customers looking to preserve principal and with a conservative risk tolerance. Unsuitable transactions in the funds resulted in losses of approximately $1.9 million to 214 Wells Fargo customers and losses of approximately $1.1 million to 214 BAI customers.

FINRA also alleged that the firms failed to reasonably supervise fund sales and train their personnel regarding the risks and features of the funds or the customers for whom the funds were a suitable investment.

With respect to Wells Fargo, FINRA alleged that, in response to potential concerns raised internally, the firm had conducted a review and prepared guidance to its sales force regarding the sale of floating rate loan fund sales but failed to distribute that information adequately.

With respect to BAI, FINRA alleged that the firm did not respond adequately to developments in the market for floating rates loan funds that affected the risks associated with them, for example by providing alerts to its sales force or adapting its supervision of fund sales.

Wells Fargo consented to a censure, a fine of $1,250,000.00, and restitution to customers in the amount of $1,981,561.70.

BAI consented to a censure, a fine of $900,000.00, and restitution to customers in the amount of $1,095,680.83.

15. *J.P. Turner & Company, LLC ("J.P. Turner")* (Dec. 5, 2013)

FINRA settled a matter in which it alleged that J.P. Turner sold unsuitable leveraged and inverse exchange-traded funds ("Non-Traditional ETFs") and effected excessive mutual fund switches in customer accounts. According to FINRA, Non-Traditional ETFs have certain risks that increase over time and in volatile markets, such risks associated with daily "reset," leverage and compounding. Non-Traditional ETFs are designed to achieve their stated objectives on a daily basis, and therefore their performance can quickly diverge from the performance of the underlying index or benchmark. This effect can be exaggerated in volatile markets.

FINRA alleged that, from January 2008 to August 2009, J.P. Turner failed to establish and maintain reasonable supervisory systems, including written procedures, to monitor Non-Traditional ETFs, and failed to provide adequate training regarding these products. J.P. Turner supervised Non-Traditional ETFs in the same manner it did traditional ETFs, and its supervisory system was not tailored to address the unique risks associated with Non-Traditional ETFs.

Representatives recommended Non-Traditional ETFs to retail brokerage customers without conducting a reasonable suitability analysis, without having an adequate understanding of the risks of Non-Traditional ETFs, and without performing reasonable due diligence. As a result, representatives made unsuitable recommendations of Non-Traditional ETFs to 27 customers, who collectively lost more than $200,000 in the investments. Additionally, in some cases, customers held Non-Traditional ETFs for extended periods of time.

FINRA also alleged that, from February 2008 to April 2010, J.P. Turner representatives engaged in a pattern of unsuitable mutual fund switching. For example, on 537 occasions, one representative recommended that customers sell mutual funds within one to 12 months after purchase.

The firm failed to establish reasonable supervisory systems, including written procedures, to monitor for trends or patterns and prevent unsuitable mutual fund switching.

Despite several red flags, including the fact that the transactions appeared on exception reports, the firm failed to reject more than 2,800 mutual fund switches. As a result, 66 customers paid $502,654 in commissions and sales charges for unsuitable mutual fund switches.

J.P. Turner consented to a censure and an order to pay $707,559 in restitution to 84 customers.

Interestingly, in setting the sanction in this matter FINRA stated that "[i]n the interests of providing full restitution to customers, FINRA imposed no fine after considering, among other things, the Firm's revenue and financial resources."

16. *Stifel, Nicolaus & Company, Inc. ("Stifel") and Century Securities ("Century")* (Jan. 9, 2014)

    FINRA settled matters with Stifel and Century (firms under common ownership) in which it alleged that from January 2009 to June 2013, the firms made unsuitable recommendations of non-traditional ETFs to certain customers because some representatives did not fully understand the unique features and specific risks associated with leveraged and inverse ETFs. Customers with conservative investment objectives who bought one or more non-traditional ETFs based on recommendations made by the firms' representatives, and who held those investments for longer periods of time, experienced net losses.

    These recommendations resulted in Stifel's retail customers buying approximately $641 million worth of nontraditional ETFs and in Century's retail customers buying approximately $31 million worth of nontraditional ETFs.

    FINRA also alleged that the firms did not have reasonable supervisory systems, including written procedures, for sales of leveraged and inverse ETFs; supervised non-traditional ETFs in the same manner as traditional ETFs; did not create a procedure to address the risk associated with longer-term holding periods for non-traditional ETFs; and failed to ensure that their registered representatives and supervisory personnel obtained adequate formal training on the products before recommending to their customers.

    Stifel consented to a fine of $450,000 and restitution of nearly $340,000 to 59 customers. Century agreed to a fine of $100,000 and restitution of $136,000 to six customers.

17. *Berthel Fisher & Company Financial Services, Inc. ("Berthel Fisher") and Securities Management & Research, Inc. ("SM&R")* (Feb. 24, 2014)

    FINRA settled a matter with Berthel Fisher and its affiliate, SM&R, in which it alleged that these two companies failed to supervise the sale of non-traded real estate investments trusts (REITs), leveraged and inverse exchange-traded funds and other alternative investments.

FINRA alleged that from January 2008 to December 2012, Berthel Fisher had inadequate supervisory systems and written procedures for sales of alternative investments such as non-traded REITs, managed futures, oil and gas programs, equipment leasing programs and business development companies.

In some instances, the firm failed to accurately calculate concentration levels for alternative investments, thus, the firm did not correctly enforce suitability standards for a number of the sales of these investments.

FINRA also alleged that Berthel Fisher failed to train its staff on individual state suitability standards.

FINRA alleged that from April 2009 to April 2012, Berthel Fisher did not have a reasonable basis for certain sales of leveraged and inverse ETFs. According to FINRA, the firm did not adequately research or review non-traditional ETFs before allowing its registered representatives to recommend them to customers, and failed to provide training to its sales force regarding these products. FINRA alleged that the firm failed to monitor the holding periods of these investments by customers, resulting in some instances in customers' losses.

FINRA alleged that Berthel Fisher recommended approximately $49.4 million worth of non-traditional ETFs in sales to more than 1,000 customers. The firm also failed to monitor the holding periods of these investments by customers, resulting in some instances in customer losses. The restitution amount for the net losses of nine customers was $13,292.53.

Berthel Fisher consented to a fine of $675,000 and restitution of $13,292.53. Securities Management consented to a fine of $100,000. As part of the settlement, Berthel Fisher agreed to retain an independent consultant to improve its supervisory procedures relating to its sale of alternative investments.

18. *LPL Financial LLC ("LPL")* (March 24, 2014)

FINRA settled a matter with LPL in which it alleged that from January 1, 2008 to July 1, 2012, LPL failed to adequately implement a supervisory system regarding the sales of alternative investments including non-traded real estate investments trusts, oil and gas partnerships, business development companies, hedge funds, managed futures, and other illiquid pass-through investments ("alternative investments") for compliance with FINRA and state suitability requirements.

In particular, LPL was alleged to have failed to put in place protocols to identify whether purchases of these products caused a client's account to

be overly concentrated in alternative investments in violation of Firm, prospectus and certain state suitability requirements.

FINRA also alleged that LPL did not adequately train its supervisory staff to analyze state suitability standards as part of their suitability reviews of alternative investments.

Finally, FINRA alleged that the Firm failed to have compliance or written supervisory procedures that delineated the supervisory steps taken with respect to alternative investment transaction reviews. According to FINRA, the written supervisory procedures failed to offer any guidance to its financial advisors or principals regarding analyzing the state suitability requirements for various alternative investments.

The Firm consented to a censure and a fine in the amount of $950,000. It also consented to undertake a comprehensive review of the adequacy of the Firm's policies, systems and procedures, and training relating to the alleged supervisory deficiencies.